Testimony

Of

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Transportation and Infrastructure Committee

Good morning. My name is Matthew Rose, and I am the Chairman, President and Chief Executive Officer of Burlington Northern Santa Fe Corporation. I am pleased to be here today. I want to thank the Committee for giving me this opportunity to testify about the state of freight rail transportation capacity, and what should be considered to ensure that the right amount of capacity is available when it is needed to meet shipper demand.

However, before I begin my testimony, I would like to briefly inform the Committee about my background. I joined the former Burlington Northern Railroad in 1993 and the following year was named Vice President, Vehicles and Machinery. After the 1995 merger of BN and the Atchison, Topeka and Santa Fe Railway, I was appointed Vice President, Chemicals and, in 1996, became Senior Vice President of the Merchandise Business Unit. In 1997, I became Chief Operations Officer responsible for coordinating transportation, maintenance, quality, purchasing, labor relations and information services. In 1999, I was appointed President and Chief Operating Officer and the next year, Chief Executive Officer. Prior to joining BN, I was Vice President, Operations for Triple Crown Services (a Norfolk Southern Subsidiary), where I had functional responsibility for all facets of the truck/rail operation.

I'd like to begin my testimony with a report from the rail industry's largest competitor, the highway. Using the well-documented forecast from the 2002 American Association of State Highway and Transportation Officials (AASHTO),

freight transportation demand is expected to more than double by 2025. Further, Global Insight forecasts Transpacific trade to triple by 2025, bringing the equivalent of 84 million TEU's (or 20-foot containers) annually into West Coast ports that today are handling about 14 million containers of that size.

Another way to look at the ASSHTO report is that domestic freight ton-mileage will grow at a little more than 2 percent compounded annually from yearend 2005 through 2020. This means the nation's truck network, according to AASHTO, will handle 4,174 billions more tons in 2020. For the rail industry, AASHTO says this translates to 1,821 billion more tons in 2020. These are staggering numbers.

The coal story is just as staggering. According to the Energy Information Administration, western coal is forecasted to grow at a 2.2 percent compound annual rate through 2025. This projection amounts to western coal production at 900 millions tons by then. In 2005, western coal production was about 450 million tons, and 415 million of those tons came from the Powder River Basin (PRB) located in Wyoming and Montana.

To put EIA's projection into perspective in terms of the importance of PRB coal to the electricity generation needs of the United States, 400 million tons of PRB coal is equivalent to 1.2 billion barrels of oil, or 50 percent of U.S. oil production. And it is equivalent to 7 trillion cubic feet of natural gas, or 35 percent of U.S. natural gas production. The comparative efficiency of PRB coal is a key reason why PRB coal is

so important to our economy – 400 million tons of PRB coal represents a $6 billion cost; its oil equivalent is a $78 billion cost at $65 a barrel, while the natural gas equivalent has a $56 billion cost at $8 per million btus.

The question that Committee needs to consider is: How are we going to handle these huge increases in freight demand, given the current transportation infrastructure and the current rate of capital investment by the private railroads and the federal government's tightening transportation budgets? It is clear, we have to change how we incent new infrastructure capacity.

The Congressional Budget Office released a study last January that supports a change. Their paper, "Freight Rail Transportation – Long-Term Issues," outlines the same capacity concerns that the rail industry has been trying to address the past couple of years. Here are some excerpts from the paper that identify the unique infrastructure situation facing the freight railroads that is not faced by the other principal, freight transportation modes.

Here are two citations from the first page of the CBO report:

> **"Some transportation experts have expressed concern that the railroads are not investing enough to meet rising demand for their services. If they cannot keep pace, the result could be higher costs not only to shippers and consumers but also for taxpayers, because demand that railroads cannot satisfy is most likely handled by trucks and thus require more spending on the construction and maintenance of highways." (Page 1)**

> **"Building new track is costly, and because track is fixed in a specific location, investing in it subjects railroads to the risk that demand will shift to other locations and that the investment will not yield an adequate return. The other major domestic freight transportation industries, trucking and water carriers, do not face that kind of risk; instead, the governments that build and maintain highways and waterways – and the taxpayers who provide their funding –bear that risk" (Page 1)**

Finally, from Page 17 of the paper:

> **"Current user-tax policies appear to tilt the playing field in favor of trucking and water carrier industries …In contrast, the railroads pay for their rights-of-way and infrastructure and often must pay local taxes on those investments as well. Those factors translate into lower private costs for truckers and water carriers an enable them to attract some freight shipments that could be carried at a lower total cost by the railroads. That encourages greater spending on highway and waterway construction than would be justified on economic grounds and leads to an inefficient use of the economy's resources,"**

Last October, when the Surface Transportation Board held a public hearing here in Washington to celebrate the 25th anniversary since Congress passed the Staggers Act, rail shippers and their trade organizations have also voiced their concerns about rail capacity and what could be done to encourage more investment in the transportation infrastructure.

This is an excerpt from The National Industrial Transportation League (NITL), which considers itself the "Voice of the Shipper" with thousands of members:

> **"…the country does <u>not</u> need railroad capacity to grow at the same pace as the growth of the economy or transportation generally; it needs to grow faster. For reasons of energy independence and environmental concerns, and because it will be even <u>more</u> difficult to expand the nation's road system easily in the face of increasing opposition to new roads through densely-settled existing communities, the railroad's share of intercity freight has to <u>grow</u>."**

And from UPS,

"UPS recognizes the capital intensive nature of the rail industry and has witnessed the equity markets' punishment of railroads that aggressively invest in their infrastructure. The railroad cost of capital dynamics are indeed challenging. While perhaps outside the purview of the Surface Transportation Board, public policy initiatives addressing infrastructure improvements, adding capacity, improving rail service, and enhancing technology should be promoted."

And the U. S. Department of Agriculture said:

"Looking forward, we must consider what can be done to encourage adequate investment in transportation infrastructure by both the railroads and private investors."

And another from NITL on the economic growth engine of the railroad industry, intermodal:

"The growth of intermodal has had profound effects on the railroad system. The traffic tends to be higher speed and higher priority compared, for example, to unit train coal or merchandise traffic, and therefore 'takes up' significant 'space' on the railroads' network. A significant part of this traffic comes from the West Coast in the form of containers imported from the Far East, a fact that has caused congestion on certain lines, and a significant need to upgrade both West Coast receiving facilities and the intercontinental network from the West."

Finally, almost five years ago on May 9, 2001, I had the honor of testifying before the Senate Committee on Commerce, Science and Transportation's Subcommittee on Surface Transportation and Merchant Marine. The three major points of my testimony then were:

- **Massive amounts of capital are needed to accommodate future growth.**

- **Railroads are disadvantaged v. other modes of transportation.**
- **Our nation is not achieving maximum economic, social and environmental benefits from its freight rail network, or its surface transportation system.**

The rest of my testimony today will focus on freight rail in general and BNSF Railway in particular. I'll comment on what the intended purpose of the Staggers Act was back in 1980; how it has contributed to the rebirth of the freight railroads; and what is needed to ensure that this economic revitalization continues so that the shipping community prospers and can count on having the freight rail capacity at the right time in the future to meet their forecasted demands.

I'll also talk about the Powder River Basin, as an example, of a prudent approach to capital investment; what we intend to do going forward; and the kind of assistance we would like to get from Congress to continue to expand the infrastructure in this coal region as well as across other parts of our network to support forecasted demand for freight rail.

First, the Staggers Rail Act of 1980: It reduced the amount of economic regulation on the railroad industry. It provided for a delicate balancing act that would enable achievement of revenue adequacy by the railroads to make infrastructure investments and remain competitive with other surface transportation modes.

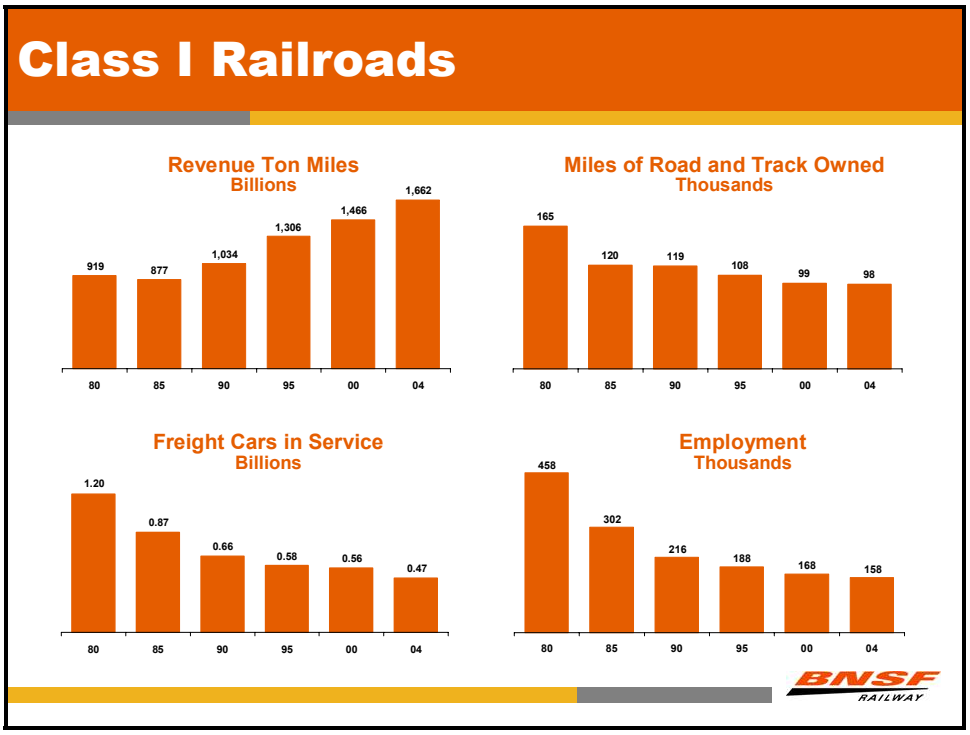
Today, the rail industry generally has a good news story to tell, some 25 years after the enactment of Staggers. BNSF, and other Class 1 railroads, are making progress toward revenue adequacy. BNSF is making such progress while it continues to handle annual volume increases, about double its normal growth rate in previous "good" economic times. This continuing volume growth and the future demand can only be met by reinvesting adequately – both to maintain the quality of infrastructure and to expand BNSF's capacity to handle more freight at the right time. This can only be done if we can reach a level of return on invested capital (ROIC) that is greater than our cost of capital, and then continue to improve our ROIC and maintain returns throughout the business cycle.

One factor that stands in the way is the fundamental "under-valuing" of freight rail. The prices BNSF charges for transportation services fell more than 50 percent, adjusted for inflation between 1980 and 2003. Only since the second half of 2003, have the railroads been able to begin receiving more value for the services provided. And in these past few years, all transportation modes have also been faced with soaring fuel prices.

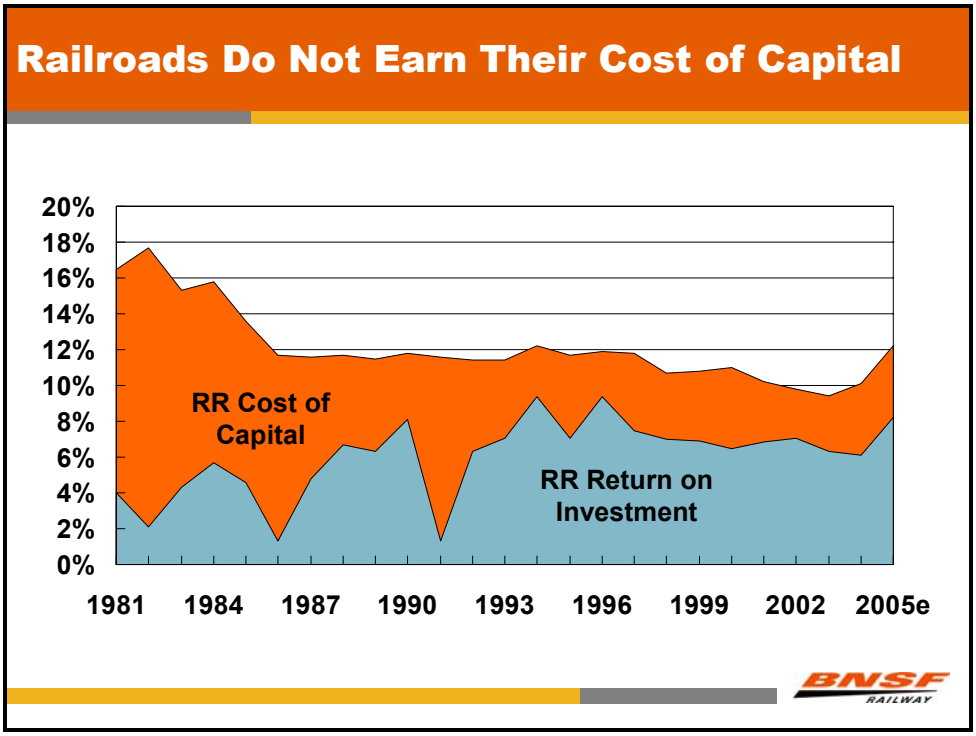
Here's quick review of how successful the Class I railroads have been as a result of the Staggers Act.

Between 1980 and 2000, the railroad industry had excess capacity. Over the last five years, GTMs or gross ton miles, have loaded up the railroads putting stress on our

infrastructures. The following charts show, as an industry, our revenue ton miles increased more than 80 percent from 1980 to 2004, while miles of track owned, freight cars in service and employment, all fell dramatically due to efficiency initiatives.

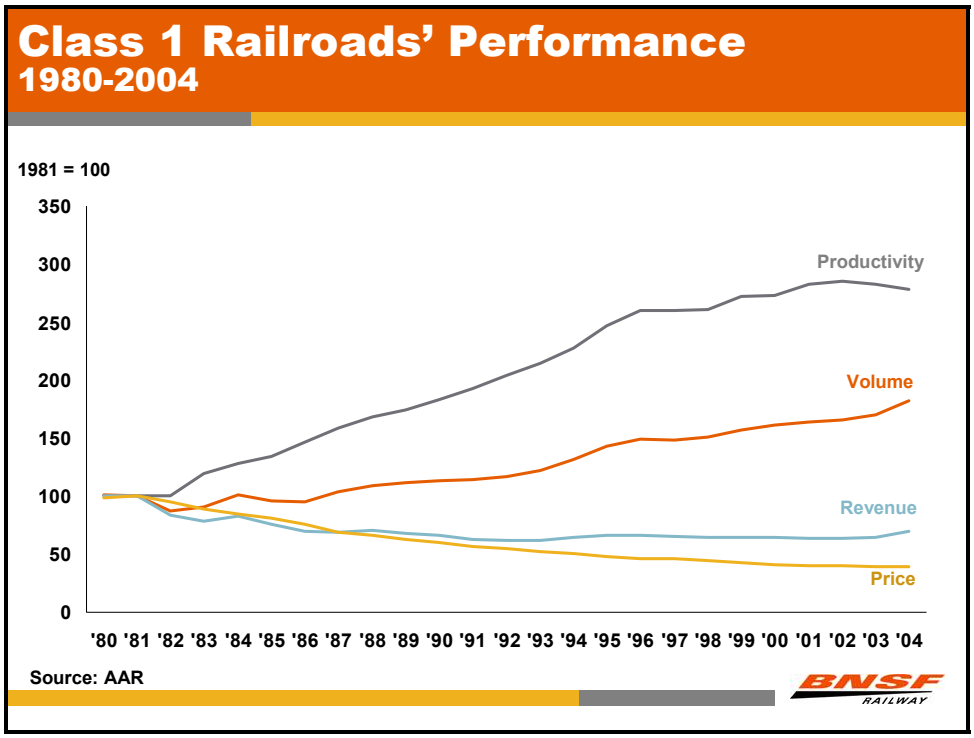


Even though BNSF has seen a definite improvement recently in its return on invested capital, Class I railroads still do not earn their cost of capital.

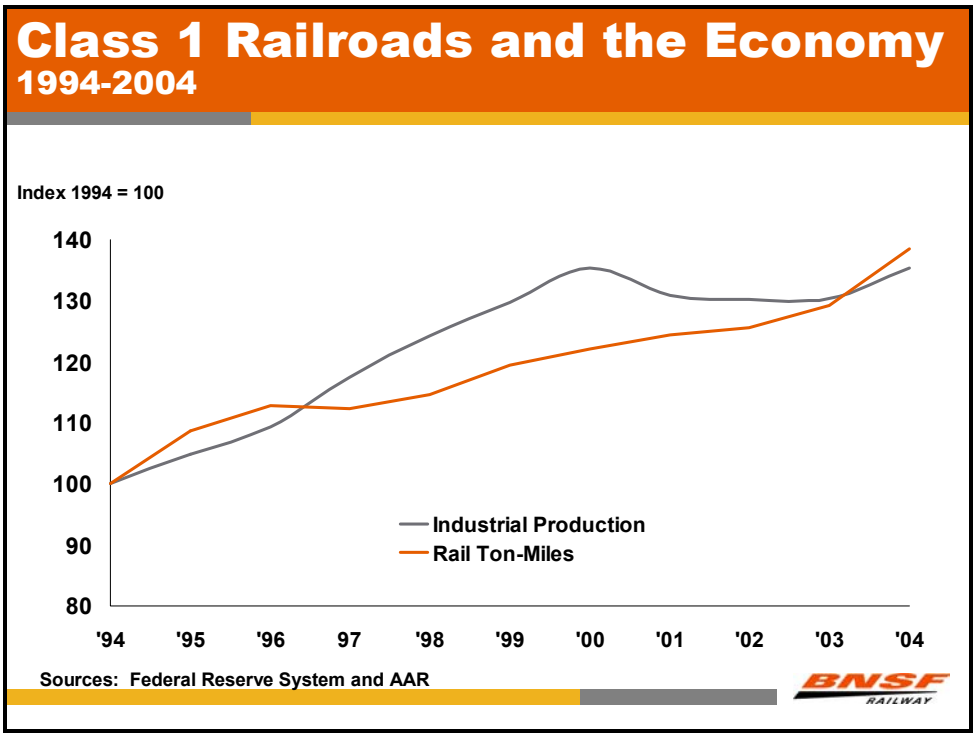


The next chart summarizes how far the rail industry has come since 1980. The passage of the Staggers Act has led to dramatic increases in railroad productivity (a 4.4 percent compound annual growth rate), which has up to now enabled the Class Is to handle sharply higher volumes (a 2.5 percent compound annual growth rate) while reducing prices (a negative 3.7 percent compound annual growth rate) as these railroads worked off its excess capacity. Today, BNSF is poised to shoulder an increased share of the transportation demand as along as it can consistently realize returns that justify new investments. And if America wants to be able to count on the rail industry even more, we must continue to embrace policies introduced with the Staggers Act that give railroads the freedom to operate in the marketplace

without artificial constraints. Bringing back the heavier hand of regulation, whether the under the guise of more competition or simply to cut back the railroad industry's ability to earn returns, would be counter productive and threatened that climate for infrastructure investment.

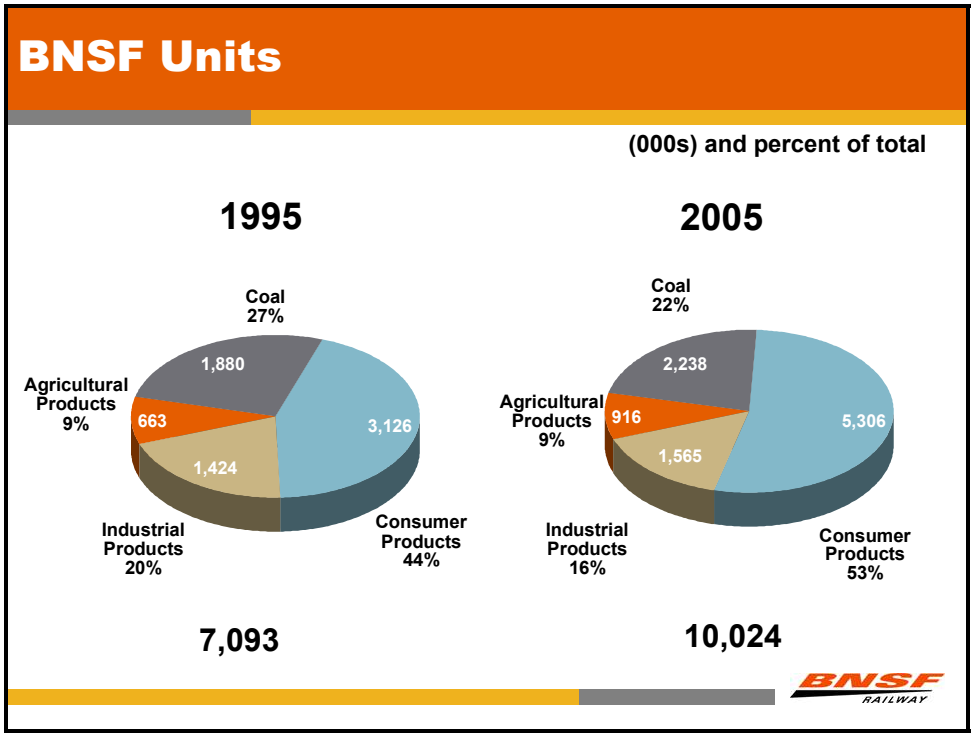


This chart shows that traditionally rail ton-miles tracked U.S. industrial production. In 2003, for the first time since 1996, rail ton-miles surpassed industrial production demonstrating the effect of the U.S. economy's shift from production to consumption.

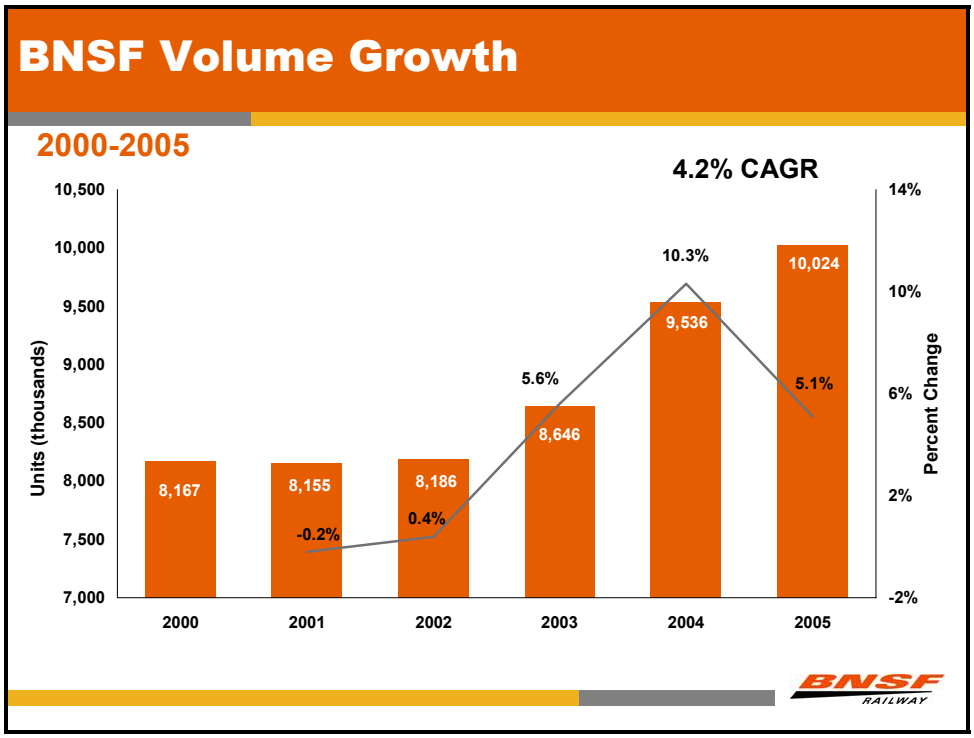


The rail industry is now entering a new era in terms of growth, driven by several major factors such as transpacific trade and coal demand, but also because truck driver shortages, fuel prices, highway congestion, agricultural trade growth and environmental considerations.

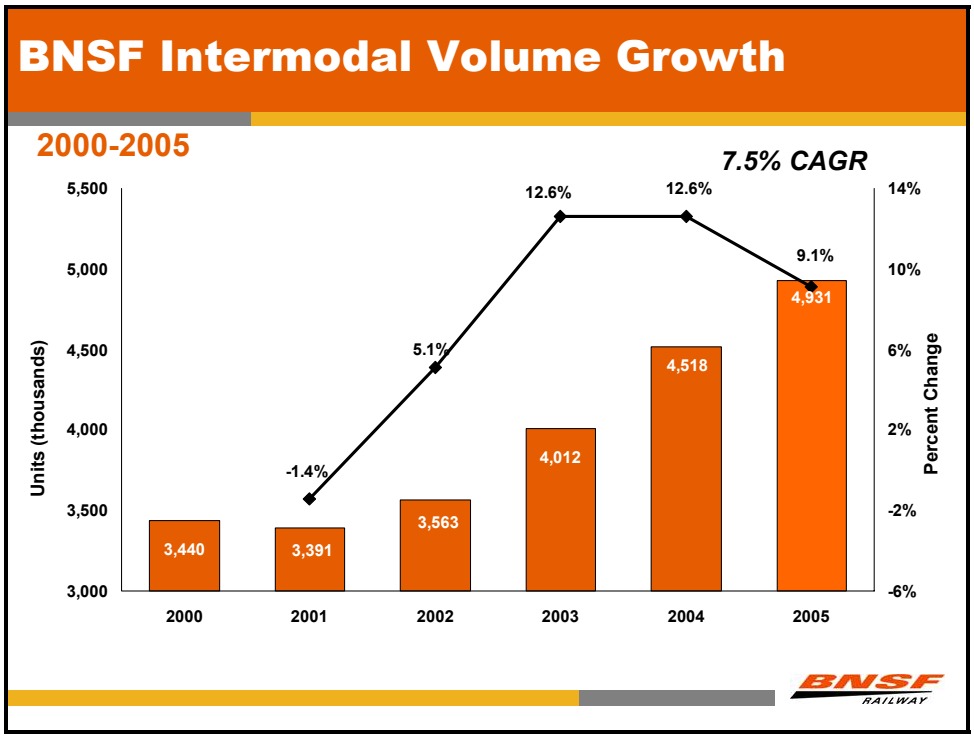
Let's look at BNSF since 1995, the year when the merger of Burlington Northern and Santa Fe Pacific became effective. These charts illustrate how dramatic the growth trends have been in the past few years. BNSF grew from a little more than 7 million units -- cars, containers and trailers -- in 1995 to a little more than 10 million units in 2005. In 2005, BNSF handled an additional 500,000 units or 50 percent of the U.S. railroad industry volume growth. All business groups – Coal, Agricultural Products, Industrial Products and Consumer Products – experience volume growth during this 11-year period, but the largest growth area was in Consumer Products, which primarily consists of intermodal traffic.



Focusing on the 2000 to 2005 time period, here's a view of BNSF's rate of volume growth each year, or 4.2 percent compounded annually over that period. BNSF has been able to achieve this rate of growth largely because of our efficiency and, to some degree, from its capital investments.

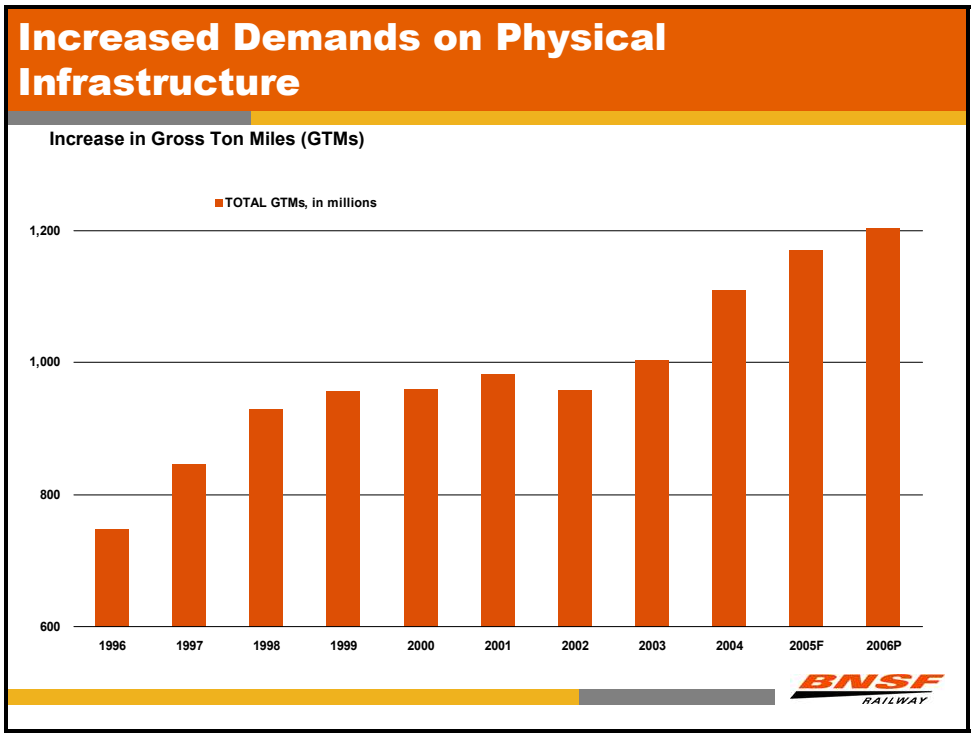


This chart illustrates the huge growth in BNSF's intermodal traffic since 2000, reflecting both the benefits from Transpacific trade as West Coast ports handle more container traffic and from the domestic trucking industry using rail for their long haul movements.



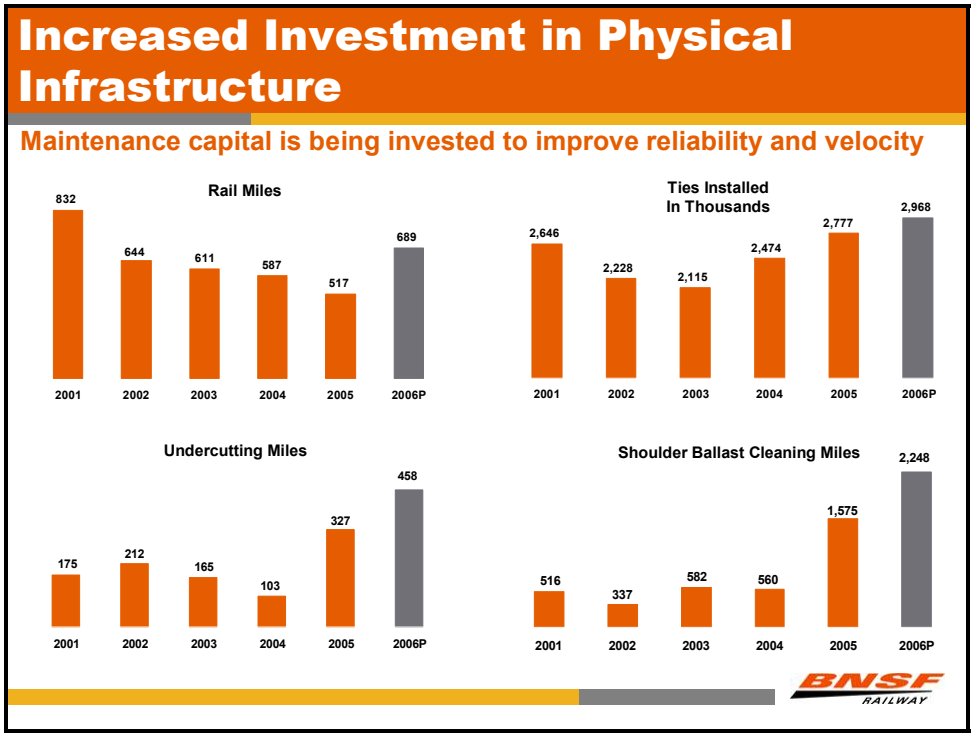
There is a lot more demand than capacity and BNSF needs to become more efficient and create more capacity. However, BNSF must also continue to invest more capital, both in the existing infrastructure to keep it strong and not constantly under undue stress, as well as to expand capacity. Expansion capital is needed to improve throughput at existing yards and intermodal hubs, and for adding more double and triple track, even fourth main lines, on core routes; building new Logistics Parks and adding locomotives and acquiring more rolling stock.

BNSF can handle the projected growth if network capacity can be expanded in the right ways at the right time. This chart shows what BNSF has been able to handle in terms of gross ton miles (GTMs) since 1996, nearly a 65-percent increase in this 10-year period. To keep growing, it's critical to have GTMs load up the railroad, but we must have a strong physical infrastructure.

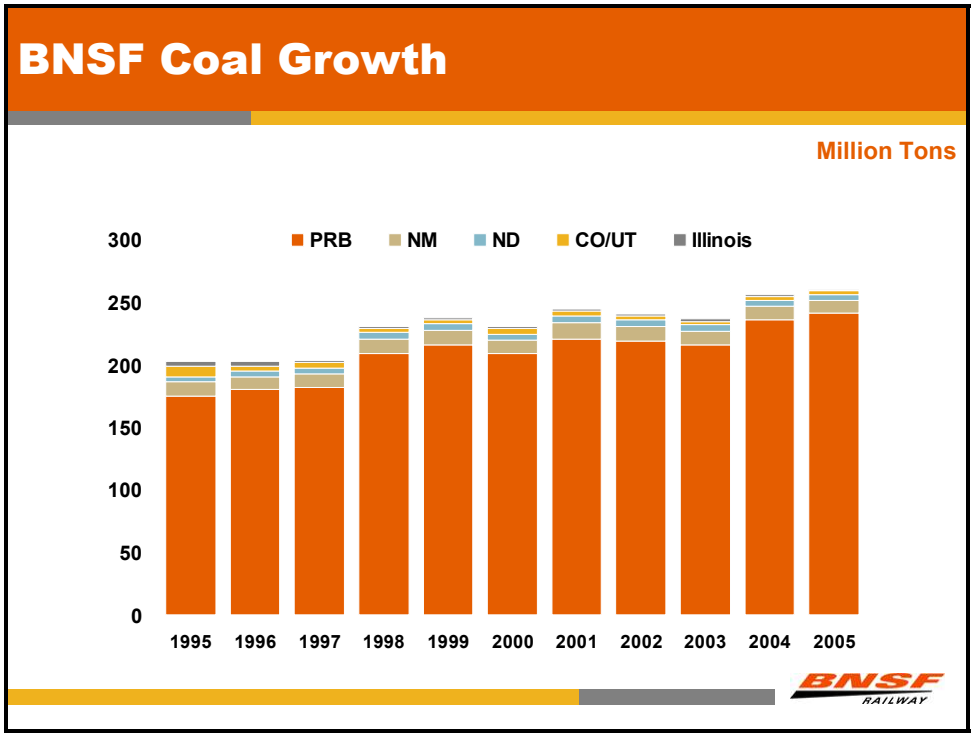


Here are the levels of investing BNSF has been making in its physical infrastructure since 2001 in terms of rail, ties, undercutting along the right of way, and ballast. BNSF is planning for another strong increase in 2006.

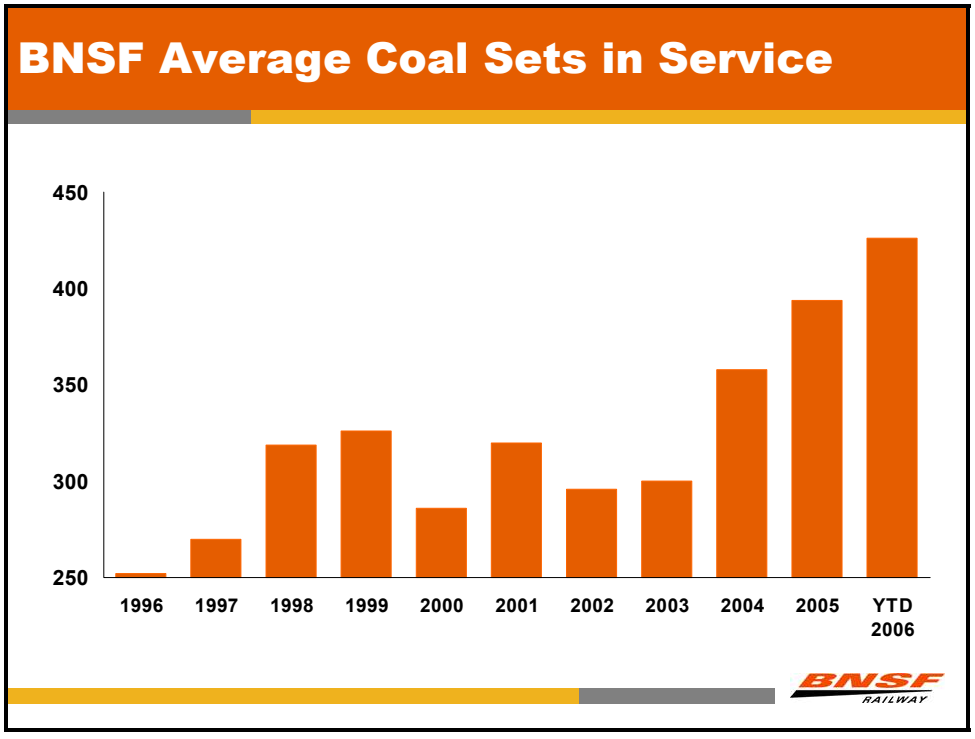
Overall, BNSF has had 30-percent increase in miles of rail laid, which has not only helped to reduce service interruptions and derailments due to rail defects, but it also has enabled us to handle the huge increase in GTMs. In 2006, BNSF will install 2.9 million ties, about 110,000 of which will be concrete ties primarily used on curved track on high density lines and on double and triple track expansions, such as on the Joint Line in the Powder River Basin (PRB). This is the route on which 65 or more loaded trains travel every 24 hours along with an equal number of empty trains to serve (10) mines and deliver coal to several dozen utilities, a growing number of which are east of the Mississippi River.



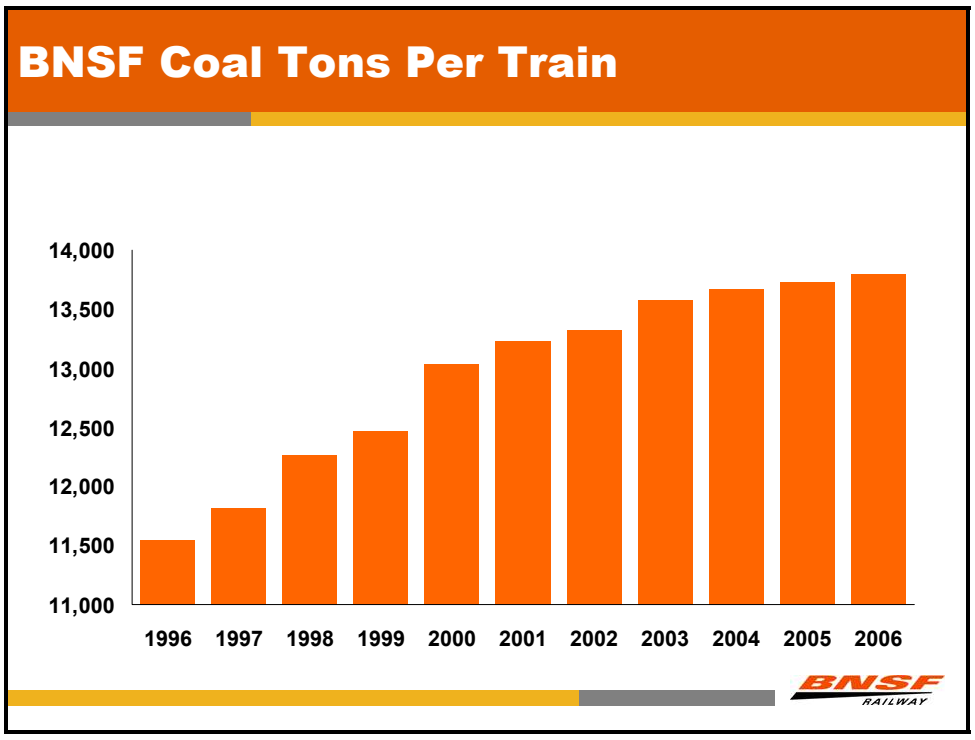
Having capacity available at the right time is not only critical for the railroads, but its customers and the U.S. economy. A clear example of this is BNSF coal business. This chart shows how improved efficiency coupled with prudent capital investment enabled BNSF to grow its coal business and leverage capacity. In the past decade, BNSF has added more than 60 million tons of coal volume to our railroad, an almost half of that just since 2003.



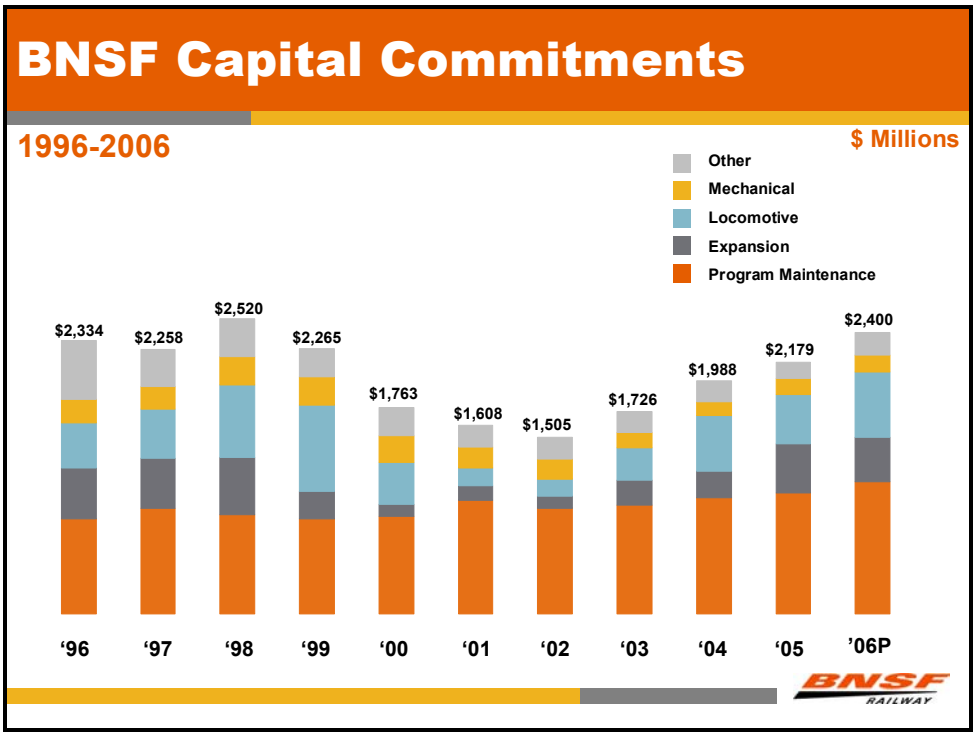
One way BNSF has met increased coal demand is through adding more than 150 coal train sets -- about 125 cars per set requiring three locomotives – to its coal network in the past decade. Today, BNSF operates about 435 coal trains every day. Some of the train sets are owned or leased by our utility customers, but all of the locomotives belong to BNSF, and each one costs in the $2 million range. Aside from these equipment investments, BNSF continues to look for ways to improve velocity and cycle times so it can improve the utilization of its coal fleet and better serve both the mines and utilities.



The chart below provides an example of productivity improvement in coal transportation. BNSF has increased the number of tons per coal train by about 2,500 tons since 1995 by loading more tons in every car. BNSF is also moving forward with other productivity measures such as better top-off systems and grooming, and precision loading; and we are also moving more and more to aluminum coal cars from steel ones. And in May 2006, we will test 150-car trains with several more customers, building on our successful earlier trials. The key to expanding this approach relates to ability of mines and utilities to handle these longer trains. We anticipate that a year from now as many as 30 of our train sets may be 150 cars long.

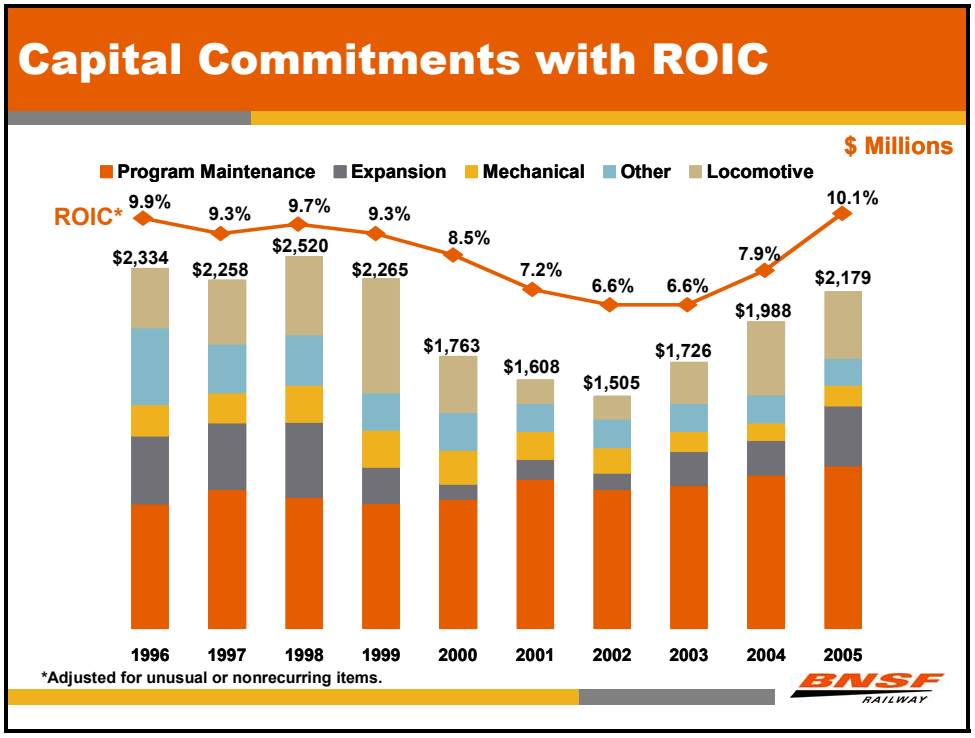


It takes a lot of money to run a low-cost, efficient railroad network. This chart highlights BNSF's capital commitments from 1996 through 2006, more than $22 billion to keep our physical infrastructure strong and to increase capacity through expanded track, yards, terminals, intermodal hubs, locomotives and new technology. In 2005, about $400 million, or 20 percent of our capital was invested in expansion. In 2006, $400 million of our capital will also go for expansion.

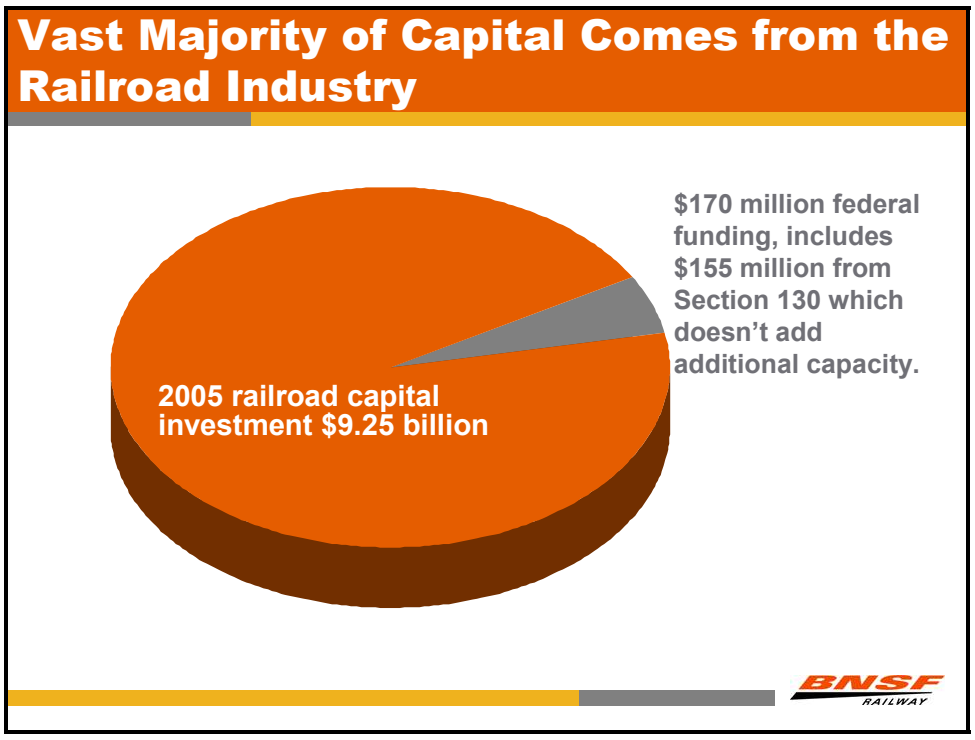


But shippers want more capacity and they want it now. We want more capacity, too, but we can only spend so much otherwise our shareholders will complain if our returns are not what they need to be.

In 2005, as you can see from this chart, we achieved a strong return on invested capital. This slide also points out the direct relationship between the rate of return on invested capital and our ability to reinvest in our business and invest for expansion of capacity. Higher returns also allow us to make the investments required to improve velocity and efficiency. We must be able to sustain our returns to reinvest at the right levels in our network. As long as volume is forecasted to grow, and we can receive proper value for our transportation services, and we do not turn back the progress Staggers made and retrench to heavier economic regulation, we will invest capital at the appropriate levels. But, we can't do it alone.



In 2005, railroads invested $9.25 billion in their networks, while federal funding only contributed $170 million. And $155 million of that $170 million was from Section 130 funding which was for grade crossings, not new capacity.



So, the question is: How do we get additional investment in rail capacity?

We have a few choices:

(1) Direct government investment, which has a place when public and private infrastructure can be improved to benefit both, but which could cause disinvestment by the rail industry if such dollars are be directed at non market-driven investments.

(2) Keep the current model with no change – railroads will continue to invest capital for expansion as long as their returns keep

improving and as long as there is no adverse change in the current regulatory system; or

(3) Supplement the current model with an investment stimulus – an incentive that is not enough to make a bad investment occur, but is enough to pull investments forward sooner in the cycle.

If we could increase expansion capital to $4 billion annually from the current level of $2 billion annually, it would have a tremendous impact on adding capacity.

That is why we support Senator Lott's 25 percent investment tax credit proposal. It is an example of public policy that will incent continued investments for capacity expansion by our industry, while providing an environmental review mechanism that allows good projects to come on line in time to meet capacity demands.

Our ability to provide an efficient rail network to handle the nation's commerce hangs in the balance. Thank you for this opportunity to express my opinion.